Volume 17 | Number 11

Article 4

5-1963

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NEW LAW PERMITS --

A "Fringe Benefit" for Farmers

A new law makes a retirement plan "fringe benefit" available to farmers and other self-employed persons. But it calls for careful thinking and advance planning even though final IRS tax regulations haven't yet been announced.

by Neil E. Harl

FRINGE BENEFITS—though widely used in nonfarm industries—are usually thought of as unavailable to farm people. Persons employed by others have long been eligible for tax-privileged benefits set up by employers. Retirement plans, health and accident plans and group term life insurance plans are examples of fringe benefits available to employees.

Most farmers, as sole proprietors, tenants or partners, are owners or part owners of their businesses and are self-employed rather than employees. A few farmers who have incorporated their businesses work for the corporation as employees. This makes them eligible for fringe benefits established by the corporation for its employees. And a few employees of larger unincorporated farm businesses have been brought under fringe-benefit plans even though the owners couldn't participate in the benefits. In total, however, few farmers qualify as employees and, therefore, few have been eligible to participate in the usual fringe benefits.

New Law . . .

A new law passed by the Congress last year makes one of the best-known fringe benefits available, in a limited way, to all self-employed people, including farmers. This new act, the Self-Employed Individuals Tax Retirement Act of 1962, is effective for taxable years beginning after 1962 (the calendar year 1963 for most farmers). Final tax regulations haven't yet been announced by the Internal Revenue Service. But the law itself indicates a need for careful thinking and planning in advance.

In essence, the law permits self-employed people, including farmers, to set aside a portion of earned income each year and to take a tax deduction for half of the amount set aside. The funds set aside accumulate tax-free and are paid out after the self-employed person's retirement, death or disability. These payments are taxed to the recipients when received, except for the portion represented by nondeductible contributions to the plan. To the extent that income tax was paid on contributions, payments from the plan may be received tax-free. Normally, when retirement benefits are received, the self-employed individual is in a lower income tax bracket than when he earned the income set aside in the fund.

Farmers in the higher income tax brackets probably will gain most from the new law. Lower-bracket taxpayers may find that the tax-saving possibilities aren't worth the trouble of setting up a plan. In some cases, the cost of setting up a plan may exceed the possible tax benefit.

Who's Eligible?

Any self-employed individual who has "earned income" may take advantage of the new law. *Earned income* is a key term in the act — allowable contributions and deductions are measured by reference to earned income. Earned income is about the same as net earnings from self-employment for a person in a personal service occupation, such as a doctor or lawyer, for example. But it's quite different for a farmer who owns his land, livestock, machinery and equipment. Individuals whose income is solely from investments aren't entitled to benefits of the new law. A farm landlord's eligibility to take advantage of the act's benefits may hinge on whether he participates personally and materially in the production of income.

Most farmers setting up plans under the act would be "owner-employees." That term includes farmers who operate their business as sole proprietors and farm partners entitled to more than 10 percent of the capital or profits of the partnership. If a sole proprietor or a partnership has regular employees, the "owner-employees" may qualify for participation in the retirement plan only if the plan includes all full-time employees who have completed 3 years of service. Part-time employees (those who normally work 20

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hours or less per week) and seasonal employees (those who normally work 5 months or less in a calendar year) may be excluded. Each employee must receive an immediate interest in contributions made to the plan on his behalf. For example, an employee's interests cannot be forfeited because he leaves his employment.

Making Contributions . . .

Regular Contributions: The contributions to a retirement plan by a *self-employed farmer* are measured by his "earned income." The act considers earned income as income resulting directly from the performance of personal service—not income from capital investments. Allowable contributions are based only on that part of income attributable to personal services. If capital is a "material income-producing factor," earned income is a reasonable allowance for personal services and can be no more than 30 percent of the net profits of the business.

Thus, a self-employed farmer with net profits of $10,000 would have earned income of only 30 percent of that amount, or $3,000. But if 30 percent of net profits is less than $2,500 and if he works substantially full time, his earned income is deemed to be $2,500. For a full-time farmer with net profits of $6,000, for example, earned income is $2,500—not 30 percent of $6,000, or $1,800. If net profit is less than $2,500, the entire net profit is treated as earned income, and the 30-percent rule is ignored.

What about a tenant? Is capital a "material income-producing factor" in the income of tenants so as to invoke the 30-percent rule? And what about farmers who are *part tenants* and *part owner-operators?* The new law is silent on these points. Much likely will depend on the facts in each case as to the percent of net profits allowed as earned income for purposes of contribution to a retirement plan. The amounts of capital used by tenants vary substantially, depending on the type of lease (and, for a cash- or crop-share tenant, on whether the tenant has his own livestock). It could be argued that some tenants use no more capital per person than do individuals in many of the so-called personal-service occupations. And, in those occupations, the 30-percent rule isn't applied.

For qualified retirement plans covering *only* owner-employees, contributions may not exceed 10 percent of an owner-employee's earned income or $2,500, whichever is less. The maximum contribution is $2,500 per year. If the plan covers *both* owner-employees and other employees, the employer's contribution for his own behalf may not exceed 10 percent of his earned income or $2,500, whichever is less. But there are no specific limitations placed on amounts which may be contributed on behalf of employees who aren't owner-employees, so long as they aren't discriminated against.

The maximum contribution of $2,500 per year for an owner-employee can be made if earned income is $25,000 or more. But if capital is a material income-producing factor and the 30-percent rule applies, net profits of $83,333 or more per year would be required for the maximum annual contribution. Therefore, high-income farmers will benefit more than low-income farmers from the new act.

Voluntary Contributions: In addition to regular contributions, *voluntary* contributions may be made to a plan which includes both employees and owner-employees. Owner-employees may contribute on their own behalf an additional 10 percent of earned income or $2,500, whichever is less. But they may not make voluntary contributions at a rate greater than the voluntary contributions by the other employees. Nor can a person who has no employees make additional voluntary contributions. To show how this works, let's look at an example (table 1) of a farmer with net profits of $10,000 and whose employees also are making voluntary contributions. The additional voluntary contributions aren't tax deductible, but earnings from them in the fund accumulate tax-free until distributed at death, disability or retirement. The principal motivation for additional voluntary contributions comes from this tax-deferring feature.

TABLE 1. Example of owner-employee voluntary contribution to retirement plan.

Net profits	$10,000
Earned income (30% of net profits)	3,000
Contribution to plan (10% of earned income)	300
Additional voluntary contribution (10% of earned income)	300
Total contributions	$ 600
Amount deductible for income-tax purposes	150

Excess contributions (those in addition to regular contributions and, if permitted, voluntary contributions) may incur a tax penalty. Exceptions are granted for amounts to be used for annuity, endowment or life insurance contracts and for purchase of special United States Government bonds.

Social Security Combination: A plan may be *integrated with social security* if the contributions for owner-employees do not exceed one-third of the total contributions. Integration with social security is optional and may influence the amount of contributions made to the plan. If a plan is integrated, contributions by self-employed people on behalf of their employees may be reduced by the amount of the employer's share of social security tax paid. If this is done, however, the owner-employee must also reduce his own contribution by the amount of self-employment tax for social security owed for the year. Integration with social security can work to the disadvantage of the owner-employee.

To show how integration with social security might work out, let's take an example (table 2) of a farmer with net profits of $10,000 who pays his employees $3,000 each per year. We'll assume that 10 percent of each employee's wages is contributed to the plan each year. We're using 1963 social security tax rates—5.4 percent on the first $4,800 of self employment income and 3⅝ percent (employer's share) on the first $4,800 of earnings of employees.

As shown in table 2, a self-employed farmer with one employee

TABLE 2. Example retirement plan integrated with social security.

	Owner-employee	One other employee	Two other employees
Net profits of owner-employee	$10,000.00	——	——
Wages paid to covered employees	——	$3,000.00	$6,000.00
Earned income	3,000.00	——	——
Contribution by employer	300.00	300.00	600.00
Social security tax paid by employer at 1963 rates	259.20 (5.4% of $4,800)	108.75 (3⅝% of $3,000)	217.50 (3⅝% of $6,000)
Net contribution under integrated plan	40.80 ($300-$259.20)	191.25 ($300-$108.75)	382.50 ($600-$217.50)
Owner-employee's percent of total contribution under integrated plan		17.6%	9.6%
Owner-employee's percent of total contribution under nonintegrated plan		50.0%	33.3%

could (if the plan is *not* integrated with social security) contribute $300 on his own behalf and $300 on behalf of the employee. The self-employed farmer would still have to pay his own social security tax of $259.20 and his share of the employee's tax, which would be $108.75. Of the $600 contributed to the retirement plan, 50 percent would be for the owner-employee. With two employees under a nonintegrated plan, a total of $900 would be contributed to the plan, one-third of which would be for the owner-employee. Again, the owner-employee would have to pay social security taxes which, in this case, would total $476.70.

In contrast, if the plan *is* integrated with social security for the examples in table 2, the owner-employee's share of the total contribution to the plan would be reduced sharply. In the case of one employee, the total contribution to the plan would be $232.05—of which the contribution for the owner-employee's benefit would be only $40.80, or 17.6 percent of the total. For a self-employed farmer with two employees, the total contribution to the plan would be $423.30—with only 9.6 percent, or $40.80, for the owner-employee. Thus, the total contributions to the plan are less if the plan is integrated with social security. And the share set aside for the farm owner is lowered. This is because contributions must be reduced by the amounts of social security taxes owed for the year by the owner-employee, not only on employees' salaries, but also on his own self-employment income.

In Later Years: Self-employed individuals are under no obligation to continue contributions for themselves in years after the plan is established. But if the plan covers employees who aren't owner-employees, contributions must be made as required by the plan. Besides pension plans with fixed percentage contributions, retirement plans may be set up with contributions based on profits. With profit-sharing plans, there's no obligation to make contributions in years of little or no profit. A specific formula is required, however, for determining contributions to be made on behalf of employees who aren't owner-employees. Owner-employees are subject to the same limitations on maximum contributions in either type of plan.

Deductibility . . .

For federal income-tax purposes, a self-employed farmer may deduct half of the allowable contribution on his own behalf—but not more than $1,250 per year. In most cases, the total amount contributed for employees who aren't owner-employees may be deducted. But no tax deduction is allowed for any additional voluntary contributions for employees or owner-employees.

The deductions are taken from gross income. Thus, a farmer may claim the deduction for contributions to the retirement plan both for himself and his employees and still qualify for the standard deduction (10 percent of adjusted gross income or $1,000, whichever is less), or he may itemize his nonbusiness deductions.

Fund Investment . . .

Contributions to a retirement fund under the new law may be held and invested in several ways. Funding may be either through the use of a trust, a custodial account established with a bank or by direct investment of funds, depending on the type of investment.

Five major choices are available for investing funds: (1) direct purchase of a new series of government bonds that are nontransferable and may not be cashed before the person named reaches age 59½, except in the event of death or disability; (2) purchase of life insurance, annuity or endowment contracts, with or without a trustee or custodian; (3) purchase of "face amount certificates" issued by investment companies (the certificates are nontransferable unless held by a trust); (4) purchase of stock of a regulated investment company — mutual fund or investment trust shares—to be held by a bank as custodian; and (5) contributions to a trust.

If a trust is used, control of investments may be retained by the employer or granted to someone else. Owner-employees, however, are prohibited from engaging in certain transactions with the trust (such as borrowing money from it or entering into transactions with it, including the purchase and sale of property). The trustee normally is a bank, which is defined to include domestic building and loan associations. But the trustee need not be a bank for a trust using annuity, endowment or life insurance contracts to fund the benefits. In these cases, even the employer may be the trustee.

Fund Distributions . . .

The new law essentially is a retirement act. Distributions to a recipient may not be made before he reaches age 59½, except in the event of permanent disability or death. Distributions must have commenced by age 70½ for owner-employees. For other employees, distribution must have started by age 70½ or the year of retirement, whichever is later.

To assure that funds aren't paid out early, the act imposes penalties for premature distributions. The penalty provisions insure that the retirement fund may not be diverted to private uses during the period of accumulation. The amounts contributed and the earnings during the period of accumulation are essentially "frozen" until distribution is authorized under the terms of the plan and the new law.

Distributions may be in periodic payments or in lump sum. As a general rule, distributions to owner-employees are taxed as ordinary income, except for the portion representing nondeductible contributions to the fund. Thus, accumulated earnings from the fund, and the amounts contributed that were tax deductible when made, are taxable to the recipient *when distributed.*

If a total lump-sum distribution is made within 1 taxable year to a self-employed individual or his beneficiary, a special averaging formula is used in computing the tax. In effect, the amount of tax due is five times the increased tax resulting from inclusion of one-fifth of the gain in the recipient's gross income in the year of distribution.

Regular employees report distributions from the employer's contribution as ordinary income. But, unlike owner-employees, regular employees may be entitled to long-term capital-gain treatment for lump-sum distributions made within 1 taxable year. Distribution of the new series of government bonds doesn't result in immediate tax liability to the recipient. The gain is reported when the bonds are redeemed.

Upon death of a self-employed person, all payments from the retirement fund to a beneficiary are subject to the federal estate tax. This may be contrasted with the differing estate-tax treatment on the death of an employee. If an employee dies, amounts received by his beneficiary aren't subject to the federal estate tax to the extent that the payments are attributable to contributions by the employer. But amounts traceable to voluntary contributions are subject to the estate tax.

Tax Savings . . .

Though the new act provides an opportunity for coupling tax saving with retirement planning, the actual tax benefits are limited substantially by the restrictions on deductible contributions. And the value of the tax benefit depends on the taxpayer's current income tax rate. To illustrate the possible tax saving, table 3 shows examples of three farmers with different income levels who are operating their businesses as sole proprietorships and with no employees.

The current tax saving shown in the top part of table 3 isn't the net tax saving, because the untaxed portion of the contribution to the retirement plan is subject to tax upon distribution. If the farmers in the examples pay income tax at the lowest rate after retirement (and if they have enough other income to equal the amount of their exemptions), the tax bills after retirement would be as shown in the lower part of the table.

Earnings on the amounts set aside haven't been considered in these examples. No tax is due on earnings of the fund until distributions are made. The tax then is based on the taxpayer's income bracket at the time of the distribution. A person's income tax rate usually is lower after retirement. So a few dollars may be saved by paying the income tax on the fund earnings after retirement.

It also was assumed in the examples that the farmers had enough other income to absorb the maximum exemptions and retirement income credits against the income tax. If they don't, part or all of the distribution would be tax-free, and the tax savings from a retirement plan under the new act would, therefore, be greater.

TABLE 3. Example tax savings from contributions to retirement plan for three net profit levels.

Tax-saving results	Farmer A	Farmer B	Farmer C
Current tax savings:			
Net profit	$10,000.00	$6,000.00	$2,000.00
Earned income			
Farmer A (30% of net profits)	3,000.00	——	——
Farmer B (up to $2,500 of net profits)	——	2,500.00	——
Farmer C (earned income = net profits)	——	——	2,000.00
Maximum contribution (10% of earned income)	300.00	250.00	200.00
Maximum tax deduction (50% of contribution)	150.00	125.00	100.00
Current tax savings	39.00 (26% of deduction)	27.50 (22% of deduction)	20.00 (20% of deduction)
Net tax savings after retirement:			
Total distribution from retirement plan	$ 300.00	$ 250.00	$ 200.00
Return of previously taxed portion of contribution	150.00	125.00	100.00
Taxable income	$ 150.00	$ 125.00	$ 100.00
Tax due (20% of taxable income)	30.00	25.00	20.00
Net tax savings	9.00 ($39-$30)	2.50 ($27.50-$25)	0.00 ($20-$20)

Briefly . . .

The new Self-Employed Individuals Tax Retirement Act offers limited opportunities for farmers and other self-employed persons to set up retirement plans with some tax advantages. If a farmer's net profits are between $8,333 and $83,333, he may contribute roughly 3 percent of the net profits to the fund and deduct half of the contribution from his gross income for federal income tax purposes. If net profits are less than $8,333, the contribution will be $250 or less, with half deductible. Earnings on contributions to the fund accumulate tax-free until distributed to the recipients. Previously untaxed portions of the distributions are taxed to the recipients at their tax rates at the time of distribution, with limited allowances for lump-sum distributions.

A word of warning is in order in setting up a qualified plan. The new law is complex, and competent legal assistance will be essential in each individual case.